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Louis J. Andrew Jr., *Wisconsin Professional Service Corporations Under the New "Kintner" Regulations*, 49 Marq. L. Rev. 564 (1966).
Available at: <http://scholarship.law.marquette.edu/mulr/vol49/iss3/5>

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COMMENTS

WISCONSIN PROFESSIONAL SERVICE CORPORATIONS UNDER THE NEW "KINTNER" REGULATIONS

Under the Internal Revenue Code of 1954 the term "corporation" encompasses associations, joint stock and insurance companies.¹ While this definition first appeared in its present form in the Revenue Act of 1917,² nothing relevant to the term appears in the congressional discussions prior to the passage of the 1917 Act. However, when it was proposed for reenactment, in 1919, Mr. Garner was questioned on the floor on the House of Representatives as to the meaning of the term "association." He told his colleagues to look the definition up in the dictionary and further stated: "I think it means a number of people, whether organized under law or voluntarily."³ This loose definition has been refined over the years as subsequent discussions will show. Generally speaking, it has now come to mean "an organization whose characteristics require it to be classified as a corporation rather than as another organization. . . ."⁴ The leading case of *United States v. Kintner*⁵ was the first major case in which a professional service organization was held to be an association and therefore taxed as a corporation. The Ninth Circuit held that an association of doctors had sufficient corporate characteristics, as set out by the Supreme Court in *Commissioner v. Morrissey*,⁶ for it to be taxed as a corporation (association). Most of the controversy that exists in this area today stems from the *Kintner* case.

At first the Commissioner refused to accept *Kintner*.⁷ This position was modified in 1957 with the announcement that new regulations would be issued.⁸ These regulations were proposed in December, 1959, and the final regulations were adopted on November 15, 1960.⁹ These were numbered 301.7701-1 and 3-7701-2, and "Kintner" regulations. Subsequent to their adoption it was hoped that Congress would amend the Code to either allow professional service organizations to be treated as "associations" for tax purposes¹⁰ or allow them certain deductions

¹ INTERNAL REVENUE CODE OF 1954, §7701.

² Revenue Act of 1917, 40 Stat. 300 (1917).

³ 56 CONG. REC. 10418 (1919).

⁴ Treas. Reg. §301.7701-2(a) (1) (1960).

⁵ *United States v. Kintner*, 216 F. 2d 418 (9th Cir. 1954).

⁶ *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

⁷ Rev. Rul. 57-546, 1957-2 CUM. BULL. 409.

⁸ Proposed Treas. Reg. §§301.7701-1 to 301.7701-11, 24 Fed. Reg. 10450 (1959).

⁹ T. D. 6503, 1962-2 CUM. BULL. 409.

¹⁰ 1963 and 1964: S. 2403 (Talmadge); H.R. 9217 (Weltner); H.R. 9690 (Davis); H.R. 9874 (McClory); H.R. 10070 (Rogers); H.R. 10418 (Halpern); H.R. 11079 (Brotzman); H.R. 11084 (Dent); H.R. 11548 (Nelsen). 1965: S. 177 (Talmadge); H.R. 697 (Weltner); H.R. 1688 (Davis); H.R. 4969 (Nelsen); H.R. 7974 (Quie); H.R. 8296 (Stephens); H.R. 8374 (Landrum); H.R. 8617 (Clark).

comparable to those granted corporations and their employees.¹¹ When these efforts failed, attention was directed to state legislatures and statutes were adopted which allowed professional service organizations to form corporations which might fit the definition of corporation (or association) under section 7701 (a) (3).¹²

In May, 1963, the Service announced that it had received numerous requests for rulings as to the tax status of professional service organizations formed under the state statutes. It refused these requests pending the issuance of new regulations.¹³ The Service issued proposed regulations in December of 1963¹⁴ and held hearings from March 4 through March 6 of 1964. On February 2, 1965, in Treasury Decision 6797,¹⁵ the final regulation was adopted in somewhat less stringent form but still retaining the basic restrictions of the proposed regulation.

The purposes of this comment are: (1) to compare the "Kintner" regulations with the new amendments finalized in Treasury Decision 6797; (2) to discuss whether the professional service corporations organized under the Wisconsin statute¹⁶ will meet the tests of the regulations as amended; and (3) to attempt to discern if the regulations, when subjected to litigation, will be considered as valid interpretation of 7701 (a) (3).

I. THE KINTNER REGULATIONS AND T. D. 6797

In order to place Treasury Decision 6797 in perspective, it is necessary to discuss first the regulations as they existed from 1960-1965.¹⁷

Section 301.7701-1¹⁸ deals with "Classification of organizations for tax purposes." Paragraph (a) defines "person" as including a number of organizations and paragraph (b) explains that there are certain classes or categories into which these various organizations fall for tax purposes. These categories include associations (which are taxed as corporations), partnerships and trusts. The tests or standards which are used in classifying an organization under the Code are interpreted in sections 301.7701-2 through 301.7701-4 of the regulations.¹⁹

Paragraph (c) of section 301.7701-1 incorporates the first change of T. D. 6797. Paragraph (c) deals with the "effect of local law." The pre-1965 part of this paragraph reiterated that for purposes of taxation, the classes into which an organization is placed are determined under the Code; and, regardless of state law classification, these organizations will be classified uniformly depending upon their nature. While

¹¹ *Ibid.*

¹² INTERNAL REVENUE CODE OF 1954, §7701.

¹³ Tax Barometer, December 2, 1961, p. 1.

¹⁴ Proposed Treas. Reg. §§301.7701-1(d), 7701-2(h), 29 Fed. Reg. 13750 (1963).

¹⁵ T.D. 6797, 1965 INT. REV. BULL., No. 9, at 38.

¹⁶ WIS. LAWS 1961, ch. 350 (WIS. STAT. §180.99).

¹⁷ *Supra* note 9.

¹⁸ Treas. Reg. §301.7701-1 (1960).

¹⁹ Treas. Reg. §§301.7701-2, 7701-4 (1960).

the Code establishes the tests or standards to determine the classification, local law determines the legal relationships and interests to which the tests of the Code are applied. To this, T. D. 6797 adds a comment to the effect that the labels applied by local law to organizations are in themselves of no importance in the classification under the Code, and give us the example of a professional service organization which was formed under a state law labeling it a professional service "corporation," which would not be taxed as a corporation merely because of its label. The effect of this addition is not clear. The pre-1965 regulations said that if an organization was classified as a trust by one state and as a corporation in another it would be classified uniformly under the Code.²⁰ The words "classification" and "label" for these purposes would seem to be almost identical, which would mean that the T. D. 6797 change is of little meaning. But the T. D. 6797 change seems to say that regardless of the uniformity of labeling by the states, the Service will look to the legal relationships and interests established under state law and apply the tests and standards of the regulations uniformly to these legal relationships and interests.

Paragraph (c),²¹ as a whole, attempts to reflect the Supreme Court's pronouncements in the relationship of local law and federal tax law. In *Morgan v. Commissioner* the Court said:

State law creates interests and rights. The federal revenue acts designate what interests and rights, so created, shall be taxed. Our duty is to ascertain the meaning of the words used to specify the thing taxed. If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest by state law.²²

The Commissioner's position appears to be that state law creation of interests and rights is limited to: (1) the legal relationship of the member of the organization among themselves; (2) the legal relationship of the members to third parties; and, (3) the interests of members of an organization in the assets of that organization. The federal tax law, according to the Commissioner,²³ presumably determines whether these legal relationships and interests established by state law are sufficient to classify the organization as an association and, therefore, taxable as a corporation.

Unfortunately, the legislative history of section 7701(a)(3)²⁴ and its predecessors is not helpful. However, in the *Morrissey* case²⁵ the

²⁰ *Supra* note 9.

²¹ *Supra* note 18.

²² *Morgan v. Commissioner*, 309 U.S. 78 (1939).

²³ Treas. Reg. §301.7701-1(c) (1960).

²⁴ INTERNAL REVENUE CODE OF 1954, §7701.

²⁵ *Supra* note 6.

Supreme Court listed what it considered to be the salient characteristics of a corporation in finding a Massachusetts business trust to be an association. These characteristics are: (1) Associates, (2) an objective to carry on a business for profit and divide the gains therefrom, (3) limited liability, (4) continuity of life, (5) centralization of management, and (6) free transferability of interests. According to this case, an organization merely has to resemble, but not be identical to, a corporation to be classified an association in the application of these characteristics. The Commissioner's interpretation of the *Morrissey* case and his application of those characteristics of a corporation will determine if an organization is to be taxed as a corporation because it is an association within the meaning of section 301.7701-2²⁶ of the regulations.

Section 301.7701-2 deals specifically with associations and sets out the tests or standards which must be met for an organization to be taxed as a corporation. T. D. 6797 changed the title of the section from "Associations" to "Associations, including organizations not previously considered to be corporations, although labeled corporations, to the tests of this section." Presumably, these rules do not apply to all corporations.

Subsection (a)²⁷ sets forth the characteristics of a corporation and how they are to be construed. The remaining subsections explain the tests that are to be used in determining if the characteristics in (a) are present. If the characteristics are present the organization will be taxed as a corporation.

These characteristics are identical to those set down in the *Morrissey* case, *supra*.²⁸ If upon the facts in each case the characteristics of the organization more nearly resemble a corporation than a partnership or a trust it will be taxed as an association.

An organization will not be classified as an association unless the organization has more corporate characteristics than noncorporate characteristics. In determining if there are more corporate characteristics, those that are common to the corporation and the organization being classified are not to be used. So that, because (1) Associates and (2) carrying on a business for profit, are common to corporations and to partnerships or professional service organizations, these characteristics will not be considered.²⁹ Therefore the organization must have more of the remaining four characteristics than not to be classified as an association.

²⁶ Treas. Reg. §301.7701-2 (1960).

²⁷ *Ibid.*

²⁸ *Ibid.*

²⁹ In the case of a one man operation the characteristic of associates would not be common to it and a corporation. Therefore, the characteristic associates could be used to determine if a one man PSC is to be taxed as a corporation.

The remaining part of subsection (a) explains the years to which 301.7701-2 is applicable. The regulations for our purposes are applicable to tax years beginning after December 31, 1960. However, where a partnership, association or a professional service organization was formed under a local law or regulatory rule authorizing the formation of such an organization, paragraph (h),³⁰ which will be described later in this comment, will not apply to an taxable years ending on or before December 31, 1964, if the organization made its return for any such year and filed it on time as if its income were subject to the corporate income tax.³¹

Subsections (b) through (e) of 301.7701-2³² deal with each of the four characteristics that will be used in determining whether the organization will be taxed as a corporation (association.).

Under subsection (b)³³ an organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will not cause a dissolution. Dissolution is defined as an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law. An agreement among the members that the business will continue upon the happening of one of the above stated events will bring about continuity of life only if permitted by local law. If any member, either by local law or agreement, has the power to dissolve the organization, continuity of life will not exist.

Centralization of management exists in subsection (c)³⁴ if any person or group of persons, not including all the members, has *continuing exclusive authority* to make all management decisions. The managers must be able to make independent business decisions on behalf of the organization without the ratification of the members of the organization. This authority may not be merely to perform ministerial tasks. The managers do not have to be members of the organization and their authority is to resemble the powers and functions of a statutory Board of Directors.

Limited liability is said to be present under subsection (d)³⁵ if under local law a creditor may seek personal satisfaction from a member of the organization where the assets of the organization are not sufficient to satisfy the claims of the creditor against the organization. Even if the member makes an agreement with another whereby he transfers his liability to the other person, if under local law, the member is still liable, limited liability does not exist.

³⁰ Treas. Reg. §301.7701-2(h) (1965).

³¹ Treas. Reg. §301.7701-2(a)(5) (1965).

³² Treas. Reg. §§301.7701-2(b)-(e) (1960).

³³ Treas. Reg. §301.7701-2(b) (1960).

³⁴ Treas. Reg. §301.7701-2(c) (1960).

³⁵ Treas. Reg. §301.7701-2(d) (1960).

If under (b), (c) or (d) the organization is formed under the Uniform Partnership Act or the Uniform Limited Partnership Act none of the characteristics explained in those sections are said to exist with the exception of the provision in (d) (2) for a general partner of a limited partnership in situations where he is not liable beyond his interest in the organization and where he is a "dummy" acting as an agent of the limited partnership.

Under (e) (i)³⁶ an organization has free transferability of interests if a member, without the consent of the other members, has the power to substitute for himself a person who is not a member of the organization, with *all of the attributes of interest* of the transferor. In other words, if the transferor has the right to share in the profits *and* participate in management but can *only* transfer his right to share in the profits without the consent of the other members free transferability does not exist.

Subsection (e) (ii)³⁷ qualifies (e) (i) to the extent that where a member can freely transfer his interest only after having offered it to the present members, a modified form of free transferability exists. Here, apparently, if there was a further requirement of consent, free transferability would not exist. The modified form will be accorded less significance than if the characteristic was present in an unmodified form.

The major change of T. D. 6797 is the addition of subsection (h) titled "Classification of professional service organizations."³⁸ Each one of (h)'s five sections refers in order to (a) through (e) of 301.7701-2 which were previously discussed. The remaining part of this section of the comment will deal with the further tests that (h) applies to professional service organizations to determine if they are to be classified as associations and the reasons why T. D. 6797 had to delete example (1) in paragraph (g).³⁹

Subparagraph (1) of (h)⁴⁰ sets out the definition of a professional service organization in a negative fashion. If an organization satisfies this definition it will have to meet the further tests of (h) along with the tests of (a) through (e). A professional service organization is an organization formed by one or more persons to engage in the business of rendering professional services for profit which *may not* be organized as an ordinary business corporation with the usual characteristics of such corporation. There are two tests implied in this definition, the first being that it must be organized as an ordinary business corporation and secondly, that it must have the usual characteristics of such

³⁶ Treas. Reg. §301.7701(e) (i) (1960).

³⁷ Treas. Reg. §301.7701-2(e) (ii) (1960).

³⁸ *Supra* note 30.

³⁹ Treas. Reg. §301.7701-2(g) (1) (1960).

⁴⁰ Treas. Reg. §301.7701-2(h) (1) (1965).

corporation while engaging in the business of rendering professional services for profit to escape the purview of (h).

If such an organization is *not* formed under local law as an ordinary business corporation it will come within the purview. However, even if under local law it is organized as an ordinary business corporation, if for some other reason it is deprived of the usual characteristics of such a corporation, it will nevertheless be subject to the further tests of (h). The additional factors that will be taken into account in determining if an organization has the required characteristics are local law, the local regulatory rules, the special requirements of the profession, its charter, articles of association, by-laws and all other facts, documents or rules relating to the formation of the organization and govern or pertain to the relationships which this organization establishes.

A rather interesting question can arise at this point; does the word "characteristic" as used in (h) (1) in speaking of characteristics of ordinary business corporations refer to the same type of "characteristic" referred to in (a).⁴¹ If it does, it seems that if an organization is engaged in the business of rendering professional services for profit then the tests of (h) (2) through (h) (5) should be applied to all such organizations and that this will be the only way that one will be able to determine if the organization satisfies the definition of (h) (1). If the word refers to different types of characteristics, then the tests of (h) (1) would have to be applied first in order to determine if the (h) (2) through (h) (5) tests are even relevant. It would seem more reasonable to believe that the former of these is the correct interpretation. No doubt characteristics other than those set out in (a) could be found. However, because these are the major characteristics of corporations, most other characteristics would be classified under one of these or would be too insignificant to be determinative.

The characteristics of a corporation, as explained earlier in this comment, were identified in (a) and explained in (b) through (e).⁴² If an organization is engaged in the business of rendering professional services for profit, then the further tests of (h) (2) through (h) (5),⁴³ using all of the factors mentioned in (h) (1), will determine if the organization should be classified as an association for tax purposes. It is very difficult to see how any organization engaged in rendering professional services for profit can escape the restrictiveness of (h). Regardless of how they are organized, all are governed by special professional regulations and local regulatory rules in such a way that they must, at least in some ways, be distinguished from ordinary business corporations. This alone is sufficient to bring them under (h).

⁴¹ Treas. Reg. §301.7701-2(a) (1) (1960).

⁴² Treas. Reg. §301.7701-2 (1960).

⁴³ Treas. Reg. §301.7701-2 (1960).

Subparagraph (h) (2)⁴⁴ generally provides that if death, insanity, bankruptcy, retirement, resignation, expulsion, professional disqualification, or election to an inconsistent public office will, under local law, cause a dissolution of the organization, the organization does not have continuity of life as explained in (b).⁴⁵ Continuity of life is described by example, stating that a business corporation has a "continuing identity as an entity"⁴⁶ which does not depend on the stockholders being employed by the organization or by an employment relationship tied to his right to share in the profits. A professional service organizations' requirements of the profession, it is said, require that that an ability to share in the profits of the organization must be coupled with an employment relationship and that in the event that the employment relationship is terminated the interest must be disposed of in some way. Thus, the continuing existence of the organization is dependent upon an agreement among the members remaining to employ the proposed successor. This type of continuity is said to be similar to that under the Uniform Partnership Act and is therefore insufficient to satisfy this characteristic.

It may be worthwhile to note here that the American Bar Association Committee on Professional Ethics and Grievances has stated an opinion in this regard. This opinion says:

The fact that the form of organization used to practice law continues as an entity, uninterrupted by death, incompetency, bankruptcy, etc., of its members does not in and of itself present any ethical problems. Continuity of life necessarily involves transferability of interests. Thus continuity of life must be attained by such restrictions on transferability of interests as may be essential to avoid ethical objections. If continuity of life may involve continuity of name, it must be kept in mind that *Canon 33* places certain restraints on the selection and use of a firm name. Furthermore, the previously discussed views of this Committee on the use of the name of a deceased person in the firm are applicable.⁴⁷

Regardless of a state statute (Wisconsin Statute 180.99), *Canon 33*⁴⁸ of the Canons of Professional Ethics may defeat a taxpayer-lawyer's claim to come under this section. This *Canon* would seem to dictate what the ethical considerations are and this may be determinative under (h) (2). *Canon 33* states generally that no name should be given to a professional legal partnership that may mislead the public, however, it goes on to say that a deceased member's name may be used if permitted

⁴⁴ Treas. Reg. §301.7701-2(h) (2) (1965).

⁴⁵ Treas. Reg. §301.7701-2(b) (1960).

⁴⁶ Treas. Reg. §301.7701-2(b) (1960).

⁴⁷ Opinions of the Committee on Professional Ethics and Grievances, Supplement to the 1957 Volume, Opinion No. 303, p. 23 (1961).

⁴⁸ American Bar Association, Canons of Professional Ethics, Canon 33.

by local custom. Local custom in Wisconsin says that a deceased member's name may be used for four years.⁴⁹ *Canon 33* goes on to state "When a member of a firm, on becoming a judge (election to an inconsistent public office), is precluded from practicing law, his name should not be continued in the firm name."⁵⁰ This would seem to limit the ability of the Wisconsin lawyer to establish continuity of life. If continuity of life is not continuity of name, the way should be clear.

Subparagraph (h) (3)⁵¹ deals with centralization of management which is said to be present where the managers of the professional service organization are vested with continuing exclusive authority to determine nine specific matters in the exercise of their authority. They must have the power to make all nine of these decisions. If these matters are interpreted broadly it appears that there will be few decisions left for the nonmanagement members to make. Apparently the Service intended this to be interpreted broadly because the regulation further provides that where the members retain the traditional professional responsibility, which means that each member makes his own professional decisions and he is personally responsible to the party he is making the decision for, centralization of management does not exist because this is essentially different from that present in an ordinary business corporation.

Some writers have pointed out that a law corporation, to take one possible example of a professional service organization, exists primarily for the practice of law and that, since a centralized management group would not seem to be controlling this in any significant degree, it would be making those business decisions which are not really at the core of the organization's activity, rather those which are on the periphery or are merely housekeeping chores.⁵² Others argue that much of the business of the large law firm is carried on by the small management group and that this is sufficient to satisfy this characteristic.⁵³

Limited liability of professional service organizations is covered in (h) (4).⁵⁴ Liability is limited if the personal liability of the members of the organization is no greater in any aspect than the liability of the shareholder-employees of an ordinary business corporation. A flat statement is then made that if a *mutual agency* relationship similar to that existing in an ordinary professional partnership must exist under local law or rules pertaining to professional practice, then limited liability is not present. The mutual agency relationship would seem to refer to a

⁴⁹ 38 WIS. BAR. BULL. 24 (1965).

⁵⁰ *Supra* note 48.

⁵¹ Treas. Reg. §301.7701-2(h) (3) (1965).

⁵² Deering, *Incorporation by Attorneys*, 42 ORE. L. REV. 93, 101 (1963).

⁵³ Ohl, *Corporate Practice of Law in New York*, 40 TAXES 263, 285 (1962).

⁵⁴ Treas. Reg. §301.7701-2(h) (4) (1965).

legal relationship; presumably a mere moral relationship would not suffice.

The Committee of Professional Ethics and Grievances of the American Bar Association, in its 1961 opinion on this subject, states:

All lawyers within an organization bear a professional responsibility for the legal service of the organization whether they are under personal liability or not. This general professional responsibility though legal liability is limited prevents any violation of *Canon 34*, when the lawyers in the organization are entitled to share of the fees collected without regard to whether they personally participated in the rendition of services.⁵⁵

This opinion goes on to state that the committee feels that its opinion makes it clear that it is possible for lawyers to participate in professional service organizations with a limited legal liability but says that a professional moral responsibility must still be present.

In view of this, it appears that, with regard to lawyers, it is not necessary that a mutual agency relationship exist but that such a relationship is merely the custom arising because the majority of law firms have been organized as partnerships over the years.

Subparagraph (h) (5)⁵⁶ deals with the characteristic of free transferability of interests. Subparagraph (h) (5) (i)⁵⁷ states that where the right of a member of a professional service organization to share in the profits of the organization is dependent upon an employment relationship, then free transferability will only exist if the member is able to transfer his right to share in the profits along with the right to an employment relationship without the consent of the other members.

Subparagraph (h) (5) (ii)⁵⁸ states that no modified form of free transferability exists where the members may transfer their interest freely but only after having offered this interest to the present members. This, the regulation states, would give the other individuals in the firm the power to determine who the firm will employ and that this is such a substantial hinderance on free transferability that the presence of this power precludes the existence of the modified form mentioned in (e) (2).⁵⁹

The last change made by T.D. 6797, which would illustrate the effect of (h), is the elimination of example (1) under (g)⁶⁰ which was referred to earlier in this comment. In this example, no limited liability existed and this would remain the same under (h) because of the flat

⁵⁵ *Supra* note 47 at p. 20.

⁵⁶ Treas. Reg. §301.7701-2(h) (5) (1965).

⁵⁷ Treas. Reg. §301.7701-2(h) (5) (i) (1965).

⁵⁸ Treas. Reg. §301.7701-2(h) (5) (ii) (1965).

⁵⁹ Treas. Reg. §301.7701-2(e) (2) (1960).

⁶⁰ Treas. Reg. §301.7701-2(g) (1) (1960).

statement given in the fact situation. It appears that under the new regulation that centralization of management would continue to exist, as the service conceded it did under the old example. Here the seven members of a medical clinic vested the management in four of its members elected by all of the members and under local law the executive committee's actions bound all of them and no one could act without its approval. The characteristics of continuity of life cannot be determined because the only reference made to this characteristic is that there is an agreement among the members stating that the organization is not to be dissolved when one of the members leaves the organization. The requirements of (h)(2) state that this characteristic must be determined without regard to any agreement among the members and that local law, applicable regulations and professional ethics will be determinative. Free transferability of interests also does exist because in the agreement among the members there is a "right of first refusal" which is not permitted under (h)(5)(ii). Thus, although its organization has centralization of management, it does not have any of the other determining characteristics.

II. WISCONSIN STATUTES 180.99 AND THE TREASURY REGULATIONS

In the 1961 session of the Wisconsin legislature, the "Service Corporation Law" for Wisconsin was enacted.⁶¹ The statute is substantially identical to those passed in seventeen other states allowing incorporation.⁶² The passage of such a statute had been urged by the members of the professions because of their feeling that they were being discriminated against by the Internal Revenue Code,⁶³ in that corporations and their employees were allowed certain deductions under the Code which they weren't entitled to as members of a partnership or sole proprietorship. In an effort to remedy this situation the professions sought assistance from the state legislature in the form of a statute that would allow them to incorporate.

Part II of this comment will attempt to analyze this statute to determine if it would permit a service corporation to meet the tests of the regulations with their T.D. 6797 amendments so that it may be taxed as a corporation under the Code.⁶⁴ Because of the technicality of

⁶¹ WIS. LAWS 1961, Ch. 350 (WIS. STAT. 180.99).

⁶² ARK. GEN. CORP. ACT, §64-2001 (1963); FLA. STAT. §§621.01 to 621.14 (1961); GA. CODE, §§84-4301 to 84-4318 (1961) (This statute permits formation of an association, however, the provisions are similar to those allowing corporations); KY. GEN. CORP. LAW, §§274.005 to 274.125 (1962); MICH. GEN. CORP. ACT, §§450.221 to 450.235 (1962); MINN. STAT., §§326.14 (1945); MO. PROF. CORP. ACT (1963); REV. CODE OF MONT., §§15-103, 15-104, 15-2101 to 15-2117 (1963); REV. STAT. OF NEB., §§1-153, 1-159 (1953); NEV. GEN. CORP. LAW, Ch. 385, Laws of 1962; N.J. GEN. CORP. LAW, §§14:19-1 to 14:19-17 (1963); N.D. PROF. CORP. ACT, (1963); OHIO REV. CODE, §§1785.01 to 1785.08 (1961); OKLA. PROF. CORP. ACT, (1963); UTAH, PROF. CORP. ACT., (1963); VT. PROF. CORP. ACT (1963); One court, Colorado, allowed incorporation by supreme court rule, effective December 5, 1961.

⁶³ INTERNAL REVENUE CODE OF 1954.

⁶⁴ T.D. 6797, 1965 INT. REV. BULL. No. 9, at 38.

this subject and in the hope of facilitating an easier understanding, the order of this part of the comment will conform to the order of the subsections of the regulations dealing with professional service organizations analyzed in Part I rather than the precise order of the subsections of 180.99.

Section 301.7701-1(c) of the regulations discusses the effect of local laws as outlined previously and makes particular reference to labels applied to organizations saying that of themselves they are of no importance.⁶⁵ Subsection 180.99(1) states that the title of the statute is "The Service Corporation Law."⁶⁶ This, therefore, would appear to give little weight to the taxpayer's argument. What the service looks to in the State laws is the legal relationships and interests established by the states.

The remaining section of the regulations, as they now exist, that are relevant in determining the status of the Service Corporation for income tax purposes are the subparagraphs under paragraph (h) of 301.7701-2 which were added by T.D. 6797.

Subparagraph (h)(1)⁶⁷ states that, if an organization is found to be a professional service organization, it will have to satisfy the further tests of (h) along with the tests of (a) through (e) in 301.7701-2, and defines a professional service organization as an organization of one or more persons formed to engage in the business of rendering professional service for profit which may not be organized as an ordinary business corporation with the usual characteristics of such corporation. As was stated in Part I of this text, it is unclear what the actual meaning of this phrase is and an attempt will be made to define it later. However, this section of the text will try to show certain characteristics which indicate that the service corporation organized under section 180.99 of the Wisconsin Statutes has or does not have such characteristics.

Subsection (2) of 180.99⁶⁸ outlines how a service corporation is to be formed. This subsection provides that any "one or more natural persons licensed, certified or registered pursuant to any provisions of the statutes *provided all have the same license, certificate or registration* may organize and own stock in a service corporation under this section."⁶⁹ (Emphasis added) This section goes on to state that a "corporation" may operate an establishment whereby services are rendered to its clients but that the services may only be rendered by officers, agents, or employees who are licensed in the field of endeavor stated in the articles of incorporation.

The fact that a separate statute had to be enacted in Chapter 180⁷⁰

⁶⁵ Treas. Reg. §301.7701-1(c) (1960).

⁶⁶ Wis. Laws 1961, ch. 350.

⁶⁷ Treas. Reg. §301.7701-2(h)(1) (1965).

⁶⁸ Wis. STAT. §180.99(1) (1963).

⁶⁹ Wis. STAT. §180.99(1) (1963).

⁷⁰ Wis. STAT. Ch. 180.

of the Wisconsin Statutes to allow a professional service organization to incorporate creates an inference that a corporation formed under section 180.99 is not an ordinary business corporation. Furthermore, the above licensing restriction, placed on the organizing, incorporating and owning stock in other corporations has no counterpart in the rest of Chapter 180. Section 180.44 merely requires that one or more natural persons over the age of twenty-one act as incorporators of other corporations formed under Chapter 180 and contains no subsection on stock ownership.⁷¹

Subsection (3) of 180.99⁷² states that a PSC organized under this statute is subject to the other sections of Chapter 180 unless 180.99 specifically deals with the matter and then 180.99 would apply. It further states that a PSC may not engage in a business activity other than that for which it was chartered. Under subsection (2) a PSC may only be chartered to render professional services. Because of this statement in subsection (2), 180.03⁷³ would not apply. Section 180.03 states that a corporation may be organized under Chapter 180 for any lawful business or purpose with certain restrictions which we are not concerned with. This would seem to set the standard for the ordinary business corporation and because of 180.99(2)'s specific statement that a PSC cannot engage in ordinary business activity this would certainly seem to deny the PSC the status of an ordinary business corporation.

Because of the emphasis placed on the term "ordinary business corporation" it might be wise to digress for a moment in an attempt to define that term. We have seen by 301.7701-1(c)⁷⁴ that the label given to the organization is of no importance in itself so that this would not be a controlling factor. The term "ordinary business corporation" is not readily definable the way it is used in this regulation. It would appear by implication, as pointed out earlier, that the definition would encompass the six *Morrissey*⁷⁵ characteristics plus, it seems, any other characteristics, such as being able to carry on any other lawful business activity and subject to no restrictions on incorporators that the Service may find useful in distinguishing a PSC from any other corporation organized under Chapter 180. In mere common parlance the term "ordinary business corporation" would not seem to embrace the professional service corporation. It appears, however, that the characteristics pointed out in the *Morrissey* case are not all of the characteristics of an ordinary business corporation, nor should they be solely controlling.

Subsection (4) of 180.99⁷⁶ allows the PSC to bear the name of

⁷¹ WIS. STAT. §180.44 (1963).

⁷² WIS. STAT. §180.99(3) (1963).

⁷³ WIS. STAT. §180.03 (1963).

⁷⁴ Treas. Reg. §301.7701-1(c) (1960).

⁷⁵ *Supra* note 6.

⁷⁶ WIS. STAT. §180.99(4) (1963).

anyone provided that if the name of a person who is not or was not a shareholder is used the PSC must record that name and the names of the shareholders in the office of the register of deeds where it is located. This, of itself, would seem to be akin to that which is required of other corporations organized under Chapter 180. However, ethical considerations of the professions would come into play here. The Canons of Professional Ethics, at least for lawyers,⁷⁷ would not allow a PSC of lawyers to include the name of a person who has never been associated with the firm to be used in its name. Under 301.7701-2(h)(1) the special regulations of the profession will be taken into account in determining its characteristics.

By 180.07⁷⁸ a corporation formed under Chapter 180, excluding 180.99, must contain the word "corporation," "incorporated," or "limited" or an abbreviation of one of these terms. Subsection (4) of 180.99 states that the word "chartered" or "limited" or their abbreviations or the word "Professional Service Corporation" or "S.C." must be used.⁷⁹ This is another difference, significant or not. The Service has stated that labels would not be determinative that an organization was a corporation but no doubt it would use this as another prong in its argument that it was not an "ordinary business corporation."

By subsection (5)⁸⁰ a PSC is required to file and record its Articles. This requirement is identical to the requirements of 180.46 and 180.48.⁸¹

Subsection (11) of 180.99⁸² requires the PSC to file an annual report with the Secretary of State by March 31 of each year showing (1) names and post office addresses of its shareholders, directors and officers, and (2) a certification that these persons are duly licensed, certified or otherwise authorized to render the professional services involved. This report must be signed by the president or vice-president and the secretary or assistant secretary and acknowledged before a notary public. The report need contain no fiscal information and is filed in lieu of the regular annual report required by Chapter 180.

The annual report of other corporations is described in 180.791⁸³ and required to be filed by 180.793(1).⁸⁴ Therefore, all corporations under Chapter 180 are required to file an annual report to the Secretary of State and the only difference between a PSC and the other corporations is a slight difference in form. This would not appear to be of enough significance for the Service to emphasize it.

After it is determined (1) whether the organization was found to

⁷⁷ American Bar Association, Canons of Professional Ethics, Canon 33.

⁷⁸ WIS. STAT. §180.07 (1963).

⁷⁹ WIS. STAT. §180.99(4) (1963).

⁸⁰ WIS. STAT. §180.99(5) (1963).

⁸¹ WIS. STAT. §§180.46, 180.48 (1963).

⁸² WIS. STAT. §180.99(11) (1963).

⁸³ WIS. STAT. §180.791 (1963).

⁸⁴ WIS. STAT. §180.793(1) (1963).

engage in the rendering of professional services for profit and (2) that it may not be organized as an "ordinary business corporation" for which it is hoped the foregoing analysis will be helpful, 301.7701-2(h)(1) says that this organization, because it is a professional service organization as the regulations define it, must satisfy the further tests of (h) along with the tests of (a) through (e) to determine if the organization has more corporate characteristics than noncorporate characteristics.

Subparagraph (h)(2) of 301.7701-2 establishes the continuity of life characteristic. It states that where professional disqualification or election to an inconsistent public office would result in the dissolution of the organization, the organization does not have continuity of life. Subsection 180.99(6)⁸⁵ states that any person not licensed, certified, or registered by a state agency may not be a stockholder, director, or officer of a PSC and specifically may not have any part in the control or ownership of the PSC. Further, if a person was licensed and is legally disqualified or is elected to an inconsistent public office, this person must sever his connection with the PSC, and must not vote shares by proxy. A corporation's failure to comply with this will be grounds for suspension or forfeiture of its franchise.

It would appear that the only time that a PSC would be dissolved for any of the previously mentioned reasons would be in the case where the sole owner of a one man corporation is professionally disqualified to own shares in a PSC. In this case, because of the requirements of 180.99(6), obviously the corporation would either have to be dissolved or continue to operate under the provisions of 180.99(10)(b)⁸⁶ whereby it could continue to operate as a business corporation organized under Chapter 180. In the latter case our problem would not arise. In the case where there are two or more stockholders who operate as employees and one man becomes disqualified under 180.99(10)(a)⁸⁷ the corporation would still have perpetual existence. Dissolution is only provided for if all members of the PSC are disqualified in some way to act as members.

Subsection (h)(2) further states that a PSC must have "continuing identity as an entity." Subsection 180.99(10)(a) states that a corporation under this section shall have perpetual existence until dissolved in accordance with the other provisions of this Chapter. By this statement it would appear that a PSC would have "continuing identity as an entity" on a par with that of other corporations organized under Chapter 180.

Subsection (10)(b) state that if all the members of the PSC should for the same reason cease to be qualified to practice in their profession, then the PSC shall operate as a business corporation organized under

⁸⁵ WIS. STAT. §180.99(6) (1963).

⁸⁶ WIS. STAT. §180.99(10)(b) (1963).

⁸⁷ WIS. STAT. §180.99(10)(a) (1963).

Chapter 180 exclusive of 180.99. Here, by the mere fact that 180.99 exists, another difference arises. This, however, should not detract from the PSC's ability to satisfy the characteristics of continuity of life.

With regard to this characteristic, one more slight problem should be discussed. The provisions of 180.99(4) have previously been discussed and the only problem that we might find with regard to this characteristic would be that upon the disqualification of one of the members his name may be restricted from use in the name of the PSC by the requirements of the profession, and in the case of disqualification that name may have to be deleted from the firm name.⁸⁸ Chapter 180 would only restrict the corporation from changing its name if under 180.07, 180.08 or 180.811⁸⁹ it attempted to change its name to one of the "reserved name[s]" under 180.08. From this it would seem that a corporation could freely change its name and still retain its "continuity identity."⁹⁰

The characteristic of centralization of management is described in 301.7701-2(h)(3).⁹¹ It states that the managers must have "continuing exclusive authority" to determine nine specific matters mentioned in Part I of this text.

The characteristic of centralization of management is not dealt with in 180.99, but by the statement in 180.99(3)⁹² that all other sections of Chapter 180 apply where 180.99 does not specifically deal with the problem; this may determine in itself that the characteristic of centralization of management is present. Section 180.30⁹³ says that the business affairs of a corporation are to be managed by a Board of Directors. Section 180.41⁹⁴ provides that appropriate officers are to be elected by the Board of Directors and that they shall have such power as is given to them by the Articles, by-laws or by resolution of the Board of Directors. There is no restriction in 180.99 as to the power which may be given to the Board of Directors or the officers. From this, it seems that there is no reason why a PSC could not have centralization of management as any other corporation might have under Chapter 180.

There is nothing in this statute which would prohibit this determination. Subsection (h)(3) of 301.7701-2 goes on to state that where the members retain "traditional professional responsibility" it is impossible for managers to determine these nine items. One of these items is that the management must have authority to determine the professional policies and procedures to be used in each individual case. This would seem to be the only sticky problem. In a law firm, for an example,

⁸⁸ American Bar Association, Canons of Professional Ethics, Canon 33.

⁸⁹ WIS. STAT. §§180.07, 180.08, 180.811 (1963).

⁹⁰ Treas. Reg. §301.7701-2(h)(2) (1965).

⁹¹ Treas. Reg. §301.7701-2(h)(3) (1965).

⁹² WIS. STAT. §180.99(3) (1963).

⁹³ WIS. STAT. §180.30 (1963).

⁹⁴ WIS. STAT. §180.41 (1963).

if we can assume⁹⁵ that when an attorney is acting while he is a member of a firm that the entire firm is acting, then certainly the managers of the firm, whether it be partnership or a PSC would have the *authority* to determine the policies and procedures in each individual case although it is not practical for them to do so. Analogous to this situation would be the policies and procedures governing the conduct of each individual salesman or each of the managers of the American Telephone and Telegraph Company. Certainly the Board of Directors or the officers would have the power to regulate these policies and procedures, but it would be hardly practical for them to do so. For these reasons it would seem that in regard to this item and also the other eight, the term "traditional professional responsibility" is rendered meaningless by its use in this context and further that the PSC could establish the characteristic of centralization of management.

The characteristic of limited liability is defined in (h)(4) of 301.7701-2.⁹⁶ As explained in Part I, an organization has the characteristic of limited liability if the members of the professional service organization have no greater liability than that of a stockholder-employee of an ordinary business corporation. If, on the other hand, under local law a mutual agency relationship exists with regard to the type of professional practice, such organization lacks limited liability.

Subsection (8) of 180.99⁹⁷ is titled "Contract and tort relationships preserved." It states that 180.99 shall not alter any contract, tort or other legal relationship between a person receiving professional services and one or more persons who are licensed, certified or registered to render such services and who are stockholders in the safe corporation; and any legal liability which may arise out of such service shall be joint and several among the stockholders of the same service corporation."⁹⁸ This part seems to refer mainly to the legal liability for malpractice and breach of contract for services. However, this subsection goes on to state that a stockholder, director, etc., shall "not be personally liable for the debts or contract obligations of the corporation."⁹⁹

Under 180.20(1)¹⁰⁰ a stockholder is not liable to the corporation or creditors for anything other than paying full consideration for the shares of stock acquired. This would seem to free a stockholder from any liability to the corporation provided that he has paid full consideration for his shares. Therefore, *as a stockholder*, the stockholder of a PSC under 180.99(8) would be subject to a greater area of liability than a stockholder of other corporations organized under Chapter 180. The liability of an employee of a PSC would also appear to be greater

⁹⁵ 7 C.J.S. *Attorney and Client* §150 (1937).

⁹⁶ Treas. Reg. §301.7701-2(h)(4) (1965).

⁹⁷ Wis. STAT. §180.99(8) (1931).

⁹⁸ Wis. STAT. §180.99(8) (1963).

⁹⁹ Wis. STAT. §180.99(8) (1963).

¹⁰⁰ Wis. STAT. §180.20(1) (1963).

than that of an employee of other corporations. It is stated in 180.99(8) that in regard to *contract debts* the PSC employee's liability is limited so that the only liability that could expand his area of liability as compared to that of the employees of other corporations would be the liability arising out of tort, contract or other action arising from the rendition of services by the members to their clients, patients, etc. which 180.99(8) declares not to be altered.

If this liability is not to be altered the question would then be what is the liability presently, and is this liability any greater than that of an agent of other corporations. It is very unclear what the legislature meant by saying that the law in this area shall not be altered. It appears that what is meant by this is that the rules of partnership law in regard to their liability for the negligence or willful acts of their partners shall apply. The Uniform Partnership Act¹⁰¹ would hold one partner liable for the acts of the other partners jointly and severally. *Corpus Juris Secundum* states:

As the employment of a member of a law firm of attorneys is that of the entire firm, an attorney is liable to a client for the negligence, lack of skill, or wrongful acts of a partner, even though he himself may have had no participation in, or knowledge of the transaction.¹⁰²

This is also the rule with regard to medical clinics.¹⁰³ The reason, it would seem, that the rules of partnership law would apply is that traditionally lawyers, doctors, etc. have engaged in practice in the form of a partnership.

If this is the case, the second step in this analysis is whether this liability is greater than that for employees or agents of other corporations. Certainly joint and several liability would not be found for all employees, agents or stockholders of other corporations, therefore a member's liability in his *employee* status is greater in a PSC.

Subparagraph (h)(5)¹⁰⁴ in defining the characteristics of free transferability of interests says that in order for this characteristic to be present in an organization where the right to share in the profits is dependent upon the existence of an employment relationship, the member must be able to transfer the right to share in the profits and the employment relationship. It further states that where the right of first refusal exists free transferability will exist in a modified form.

Subsection (10)(c)¹⁰⁵ provides that within 90 days of a members disqualification for membership either the shares of the disqualified member must be transferred to another who is eligible or the corporation

¹⁰¹ WIS. STAT. §123.10 (1963).

¹⁰² *Supra* note 95.

¹⁰³ 70 C.J.S. *Physicians and Surgeons*, §54 (1937).

¹⁰⁴ Treas. Reg. §301.7701-2(h)(5) (1965).

¹⁰⁵ WIS. STAT. §180.99(10)(c) (1963).

must redeem the shares at book value, and further spells out what is meant by book value. It says that nothing in this section shall limit the right of the parties to make other arrangements to transfer shares provided that within 90 days all of the stock is transferred.

In this case, merely because all owners are required to be licensed in the profession practiced, should the statute¹⁰⁶ be construed to require the existence of an employment relationship? Why could not the members agree that although a member's interest could be transferred to anyone (licensed), the right to employment could not be? By the statute the right to share in the profits is not dependent on an employment relationship. This could clearly be handled in the Articles or By-laws. Free transferability does not seem to be a salient characteristic of a Corporation.¹⁰⁷ Aside from this fact, it would seem that the free transferability requirement could be satisfied by the statute.

In conclusion, it appears that a Professional Service Corporation organized under the Wisconsin statutes and found under 301.7701-1 (h)(1) to be a professional service organization will meet the tests of (h)(2) through (h)(6)¹⁰⁸ with regard to continuity of life, centralization of management and free transferability of interests. However, it appears that it would not satisfy the test for limited liability.

III. THE REGULATIONS AND SECTION 7701(a)(3) OF THE CODE

In an effort to determine if 301.7701-1 through 301-7701-2¹⁰⁹ are valid interpretations of Section 7701 of the Code,¹¹⁰ we first must look to find some authority for the Service to issue such regulations and further, determine what force and effect these regulations are intended to have.

Professor Davis in his administrative law treatise states that the rules of administrative agencies can be divided into legislative and interpretive rules.¹¹¹ He gives as the clearest case of a legislative rule one issued under a statute which "has conferred power upon an agency to issue the rule and the statute provides that the rule, if within the granted power, shall have the force of law."¹¹² An example of this type of rule in the Code would be the provisions of Section 1502¹¹³ stating that in the filing of consolidated returns the Secretary or his delegate may prescribe regulations so that the consolidated return would reflect the accurate income tax liability of the several persons entitled

¹⁰⁶ WIS. STAT. §180.99(6) (1963).

¹⁰⁷ Closely held corporations generally have business continuation agreements and buy-sell agreements or at least they should be advised to do so. This is a limited restriction on free transferability yet close corporations are a large percentage of the total corporations in the United States.

¹⁰⁸ Treas. Reg. §§301.7701-2(h)(2)-(h)(6) (1965).

¹⁰⁹ Treas. Reg. §§301.7701-1 to 301.7701-2 (1965).

¹¹⁰ INTERNAL REVENUE CODE OF 1954, §7701.

¹¹¹ 1 Davis, *Administrative Law Treatise* 298 (1958).

¹¹² *Supra* note 111, p. 299.

¹¹³ INTERNAL REVENUE CODE OF 1954, §7805.

to file the return. The extent of the court's power of review would be limited to determining if the regulation is within the granted power, issued pursuant to proper procedure and reasonable.¹¹⁴

On the other hand, Professor Davis says that interpretive rules can rest on statutory authorization or more commonly they impliedly grow out of the work assigned by the legislative body to the agency.¹¹⁵ There is no specific grant of authority to the Service for the issuance of regulations contained in Section 7701, so that the provisions of Section 7805 generally giving to the Service authority to issue Rules and Regulations would seem to apply. It says the Secretary or his delegate "shall prescribe all needful rules and regulations for the enforcement of this title. . . ."¹¹⁶ The question would arise as to whether this is a legislative or interpretive rule. On its face it is unclear as to whether this authorizes the issuance of legislative or merely interpretive regulations, but Davis states that "The great bulk of Treasury Regulations clearly are interpretive rules, despite the provisions of 7805. . . ."¹¹⁷ In support of his argument he cites dicta of the Supreme Court in *Skidmore v. Swift*: "This court has long given considerable and in some cases decisive weight to Treasury decisions and to interpretive regulations of the Treasury and other bodies that were not of adversary origin."¹¹⁸ Davis, in another section of his treatise, goes on to show Congressional intent for his analysis.¹¹⁹ If Professor Davis' conclusion is correct, it would appear that in the case of an interpretive rule the court in reviewing it would first look for Congressional intent. As was pointed out in Part I of this text, there is no evidence of Congressional intent available specifically referring to Section 7701(a)(3). In such a case the court could (1) give force of law to the rule, (2) disregard the rule and substitute its own judgment, or (3) take a middle-of-the-road course giving the rule some authoritative weight. In short, they are able to substitute their judgment for that of the administrative body and questions of desirability and wisdom.¹²⁰ There are several factors that could determine which course the court may choose to follow, such as the competence of the judges in the area, the length of time that the rule has been in effect, and whether or not the statute has been re-enacted with the regulation outstanding. The last of these would not be relevant in our case because the Code was passed in 1954 and the present regulations came out in 1960 and 1965. Similarly, it is doubtful whether they have been in effect long enough to give them greater weight. Davis states that it is impossible to pinpoint the factors which

¹¹⁴ *Supra* note 111, p. 298.

¹¹⁵ *Ibid.*

¹¹⁶ INTERNAL REVENUE CODE OF 1954, §7805.

¹¹⁷ *Supra* note 111, p. 300.

¹¹⁸ *Supra* note 111, p. 301.

¹¹⁹ *Supra* note 111, p. 310 and p. 311.

¹²⁰ *Supra* note 111, p. 315.

the courts give the most weight to in a tax case. He suggests that a plurality of factors will no doubt control, not the least of which would be the judge's agreement or disagreement with the regulation.¹²¹

It must be borne in mind that the lower courts will be bound by a Supreme Court decision in the area and in review the Supreme Court might well give great weight to its prior decision, particularly since it antedated the adoption of the 1939 and 1954 Codes which made no change in Section 7701. At the time of preparation of this text there are no cases construing this regulation with its T.D. 6797 amendments.¹²² Hence, it would appear that the only guidelines we might have that would allow us to predict the interpretation to be given by the courts would be those of the Supreme Court in the *Morrissey* case.¹²³ In an attempt to use these guidelines in the case of a professional service organization it can be said that they, at best, are sketchy. As previously mentioned, in the *Morrissey* case the Service sought to tax a so-called Massachusetts Trust as an association (thereby taxed as a corporation) and the court found in favor of the Service. The Court in that case did say some things that are of current importance. The Court stated that "The inclusion of associations with corporations [in the definition of 7701] implies resemblance; but it is resemblance and not identity."¹²⁴ it further provides what the six salient corporate characteristics are, as stated earlier, but gives little elaboration. This would seem to support the Service's interpretation as to what the general characteristics are, but is not helpful as to whether or not the Service's attempt to define these characteristics in more detail is reasonable or not.

LOUIS J. ANDREW, JR.

¹²¹ *Supra* note 111, p. 315.

¹²² Treas. Reg. §§301.7701-1, 7701-2 (1965).

¹²³ *Supra* note 6.

¹²⁴ *Supra* note 6, p. 357.